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China's Fiscal and Monetary Policy

Summary

Beijing's ability to control macroeconomic variables directly has diminished markedly over the past few years as economic decisionmaking authority has devolved to lower levels. As a result, the government has started to experiment with Western demand-management policies. The banking system was completely restructured to make monetary policy a viable option, and fiscal tools--including issuance of treasury bonds and alterations in government spending patterns--have been put to use. The performance of China's new fiscal and monetary tools last year was singularly unsuccessful, however, as bank credit mushroomed, the money supply soared, government spending rose faster than planned, and the budget deficit widened. Beijing has reacted to these problems by giving the central bank greater control over the issuance of both credit and wages, and by proposing significant budget cuts in administrative outlays. In an effort to control the rapid growth of non-budgetary government spending, Beijing will impose steeper taxes on local investment projects. The leadership appears committed to continue the experiment with fiscal and monetary policy, but until major price reform is accomplished, we expect Beijing to remain dissatisfied with the results. [redacted] 25X1

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Questions and comments are welcome and should be addressed to the Chief, Domestic Policy Branch, China Division, OEA at [redacted]

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Introduction

During most of the past 30 years China had little need to use fiscal or monetary policy for demand management. Unlike market economies, where unanticipated shifts in private investment occasionally cause sharp changes in economic activity, the bulk of investment in China has been government controlled. Annual investment decisions were part of the planning process and funds were channeled into sectors that Beijing designated as top priority. With investment largely controlled by the government, the only source of potential macroeconomic instability was the savings and consumption pattern in the household sector. Here tight wage and price controls were the main tools for curtailing excess demand and dampening inflationary pressures. 25X1

Recently, however, Beijing has given up much of the direct control it once exerted over domestic investment decisions. Economic reforms introduced over the past four years have significantly increased the decisionmaking authority of local firms and individual households. Correspondingly, the potential for fluctuations in aggregate demand has greatly increased, while the government's ability to control such fluctuations has declined. Offsetting these negative aspects are the gains in productivity--mostly in rural areas--that can be attributed, in part at least, to the economic reforms. Beijing's present dilemma is how to strengthen control over economic behavior without weakening the reform package and cutting productivity. In pursuit of this goal the government is expanding its available options for conducting effective fiscal and monetary policy. 25X1

Experimenting with Fiscal Tools

In an effort to regain at least a portion of the control it once had over economic behavior without disrupting the economic reforms, Beijing began in 1979 to utilize the few fiscal tools at its disposal. Its first priority was to curb mounting inflationary pressures. While using moral suasion to encourage cutbacks in extrabudgetary investment, the government cut sharply into its own spending. Budgetary expenditure on capital construction was flat in 1979, then fell 17 percent in 1980 and 28 percent the following year. Defense expenditures--after rising sharply in 1979 to finance the war with Vietnam--were also cut in 1980 and 1981. Beijing's counsel to reduce extrabudgetary investment was fairly effective in 1979--probably because local enterprises were unsure how much real decisionmaking authority they had--but in 1980 local firms moved into an expansionary phase and extrabudgetary investment doubled to almost 21 billion yuan. Extrabudgetary investment grew to 28 billion yuan in 1982, fell to 25 billion yuan in 1983, and climbed last year to nearly 42 billion yuan. 25X1

The attempt to relieve pressure by cutting back government investment proved less than totally effective. In the first place, reductions were offset by other government outlays. Subsidies, for example, rose 21.6 billion

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yuan between 1979 and 1982, more than offsetting the 21.6 billion yuan decline in government spending for capital construction. Furthermore, by withdrawing resources from much-needed infrastructure projects the government's investment cutbacks may have harmed China's future growth potential. The share of total expenditures allocated to key projects dropped from 42 percent in 1978 to 30 percent in 1982. [redacted] 25X1

Recognizing the deficiencies in its initial attempts at demand-management Beijing began experimenting with new fiscal tools. In 1981 it issued nearly 5 billion yuan in treasury bonds, which were purchased almost entirely on an involuntary basis. The bonds proved to be remarkably useful fiscal tools, both crowding out funds that otherwise would have gone to extrabudgetary investment and, perhaps more importantly, enabling the government for the first time to operate in the red without simultaneously expanding the domestic money supply. Beijing issued an additional 4 billion yuan in bonds annually during 1981-1984. About half the more recent issues have gone to organizations and half to individuals. The latter now carry a 9-percent annual interest rate as opposed to only 5 percent for the former. [redacted] 25X1

In 1983 several additional steps were taken to strengthen fiscal control. A 10-percent tax on extrabudgetary spending was introduced to slow unwanted investment and, at the same time, to help finance major infrastructural projects. Another major policy change was the replacement of the system of profit remittances with a system of profit taxation. The new program is designed to put more pressure on losing enterprises by ending automatic subsidies and to encourage other enterprises to earn higher profits on the understanding that these will be shared with the tax authorities rather than be confiscated. Surcharges have been levied against inventories to discourage the production of unwanted merchandise. Revenue collection has also been strengthened with auditing units nationwide cracking down on tax fraud. More than 190,000 auditors were mobilized to spot-check one-third of the nation's enterprises and establishments. Violations amounting to 3.5 billion yuan were discovered, 1.9 billion of which were owed to the state. [redacted] 25X1

Despite these changes, government spending grew faster than planned last year, widening the budget deficit and prompting the leadership to impose a sizable cut in 1985 administrative outlays. China's planning and finance chiefs stated at a recent National People's Congress session that in 1985 central control must be exerted over capital construction spending, which grew by nearly 24 percent last year. Premier Zhao Ziyang claimed at the same session that taxes will be used more effectively this year to control the growth of extrabudgetary investment. [redacted] 25X1

Making Monetary Policy an Option

Perhaps the most convincing evidence of China's willingness to experiment with market-oriented, demand-management tools has been its reform of the

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banking system. Over the past four years Beijing has been setting up a network of commercial and industrial banks to relieve the People's Bank of China (PBOC) of the burden of exercising financial supervision over public enterprises. The major goal of banking reform appears to be to create a banking system capable of rapidly moving surplus funds to locations of greatest economic need. At present, most fixed and working capital requirements continue to be satisfied with budgetary grants channeled through the banking sytem, but increasingly funds are being loaned on the basis of creditworthiness. As an integral part of banking reforms, greater use is also being made of interest rates to influence economic decisionmaking at the micro level. Interest rates paid on deposits have been raised four times since 1978; the increases have more than kept pace with inflation. New types of deposits have been created, broadening the range of financial assets individuals can choose from. In 1982, enterprises and organizations were for the first time permitted to hold time deposits, which earn higher interest payments. [redacted] 25X1

Despite the changes made by banking reform, the monetary authorities last year exerted little independent control over economic activity. Although the PBOC, with its more specialized duties, should now be able to monitor credit expansion, deposits, and the rate of growth of currency in circulation more closely, the bank in 1984 failed to prevent a massive credit expansion and commensurately large surge in the money supply. Bank loans rose by nearly 30 percent last year and wages and worker bonus payments shot up by almost 20 percent, seriously embarrassing the reformers within the leadership. Beijing reacted to last year's disappointing performance by appointing Chen Muhua--former foreign trade minister and believed to be a strong proponent of exercising central control over subordinate economic units--to head the Chinese central bank. The PBOC reportedly has also been given the authority to monitor the wage and bonus funds of state-owned enterprises and to tighten 25X1 credit policy. [redacted] the State Council recently signed off on a new set of credit regulations that gives banks written authority to take over the pledged assets of all enterprises unwilling or unable to repay loans. [redacted] 25X1

Where to Next?

While it is clear that the Chinese remain concerned about their lack of control over economic behavior, it is equally clear that they remain deeply committed to reform. The pragmatic leadership is convinced that only by taking a more market-oriented approach can China reduce the tremendous waste and inefficiency that have characterized its economy over the past 20 years. As a result, we expect to see the experiment with fiscal and monetary policy pick up steam--despite recent setbacks. [redacted] 25X1

While the experiment with monetary and fiscal policy has provided some benefits already, it is unlikely that Beijing will achieve the results it

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expects. Most of the remaining major economic problems--including the emergence of inefficient industries producing unwanted products, continued waste of energy resources, and the siphoning off of materials needed for priority projects--are directly related to China's irrational pricing system. Price reform has been declared by the Central Committee as one of China's key goals to be accomplished over the next five years, but all indicators suggest that Beijing will move very deliberately and cautiously. Without major progress in price reform, Beijing could become frustrated by its inability to overcome serious economic difficulties, and could move back toward more direct administrative control over the economy.

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